

(ii) To prevent the shifting of basis from the contributed property to other assets of T, the Commissioner may allocate \$10,800 of the AGUB to the land, leaving \$98,000 to be allocated to the building. See paragraph (f) of this section. Otherwise, applying the allocation rules of § 1.338-6 would, on these facts, result in an allocation to the recently contributed land of an amount less than its value of \$10,800, with the difference being allocated to the building already held by T.

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**§ 1.338-6 Allocation of ADSP and AGUB among target assets.**

(a) *Scope*—(1) *In general.* This section prescribes rules for allocating ADSP and AGUB among the acquisition date assets of a target for which a section 338 election is made.

(2) *Fair market value*—(i) *In general.* Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale tax consequences, the fair market value of any property subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target's basis in such property.)

(ii) *Transaction costs.* Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) *Internal Revenue Service authority.* In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties.

(b) *General rule for allocating ADSP and AGUB*—(1) *Reduction in the amount of consideration for Class I assets.* Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I assets. Class I as-

sets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) *Other assets*—(i) *In general.* Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V assets so held in such proportion, then among Class VI assets so held in such proportion, and finally to Class VII assets. If an asset is described below as includible in more than one class, then it is included in such class with the lower or lowest class number (for instance, Class III has a lower class number than Class IV).

(ii) *Class II assets.* Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and § 1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) *Class III assets.* Class III assets are assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include—

(A) Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;

(B) Contingent debt instruments subject to § 1.1275-4, § 1.483-4, or section 988, unless the instrument is subject to the non-contingent bond method of § 1.1275-4(b) or is described in § 1.988-2(b)(2)(i)(B)(2); and

(C) Debt instruments convertible into the stock of the issuer or other property.

(iv) *Class IV assets.* Class IV assets are all assets in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) *Class V assets.* Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) *Class VI assets.* Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) *Class VII assets.* Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

(3) *Other items designated by the Internal Revenue Service.* Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Service (see § 601.601(d)(2) of this chapter).

(c) *Certain limitations and other rules for allocation to an asset—*(1) *Allocation not to exceed fair market value.* The amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) *Allocation subject to other rules.* The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a con-

tract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, section 197(f)(5) applies in determining the amount of AGUB allocated to an amortizable section 197 intangible resulting from an assumption-reinsurance transaction.

(3) *Special rule for allocating AGUB when purchasing corporation has non-recently purchased stock—*(i) *Scope.* This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and § 1.338-5(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under § 1.338-5(b).

(ii) *Determination of hypothetical purchase price.* Hypothetical purchase price is the AGUB that would result if a gain recognition election were made.

(iii) *Allocation of AGUB.* Subject to the limitations in paragraphs (c)(1) and (2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) *Liabilities taken into account in determining amount realized on subsequent disposition.* In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, § 1.1001-2(a)(3) shall not apply to any liability that was taken into account in AGUB.

(d) *Examples.* The following examples illustrate §§ 1.338-4, 1.338-5, and this section:

*Example 1.* (i) T owns 90 percent of the outstanding TI stock. P purchases 100 percent of

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the outstanding T stock for \$2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is \$2,000 (i.e., \$2,000 + 1/1).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities) .....	\$700
Taxes Payable .....	300
<b>Total .....</b>	<b>1,000</b>

(iii) The AGUB of T is determined as follows:

Grossed-up basis .....	\$2,000
Total liabilities .....	1,000
<b>AGUB .....</b>	<b>3,000</b>

(iv) Assume that ADSP is also \$3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II, III, IV, and V assets are as follows:

Asset class	Asset	Fair market value
I .....	Cash .....	*\$200
II .....	Portfolio of actively traded securities .....	300
III .....	Accounts receivable .....	600
IV .....	Inventory .....	300
V .....	Building .....	800
V .....	Land .....	200
V .....	Investment in T1 .....	450
	<b>Total .....</b>	<b>2,850</b>

\*Amount.

(vi) Under paragraph (b)(1) of this section, the amount of ADSP and AGUB allocable to T's Class II, III, IV, and V assets is reduced by the amount of cash to \$2,800, i.e., \$3,000—\$200. \$300 of ADSP and of AGUB is then allocated to actively traded securities. \$600 of ADSP and of AGUB is then allocated to accounts receivable. \$300 of ADSP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSP and of AGUB is \$1,600 (i.e., \$3,000—(\$200 + \$300 + \$600 + \$300)), an amount which exceeds the sum of the fair market values of T's Class V assets, the amount of ADSP and of AGUB allocated to each Class V asset is its fair market value:

Building .....	\$800
Land .....	200
Investment in T1 .....	450
<b>Total .....</b>	<b>1,450</b>

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T's Class VII assets (goodwill and going concern value) is \$150, i.e., \$1,600—\$1,450.

(viii) The grossed-up basis of the T1 stock is \$500, i.e., \$450 × 1/9.

(ix) The liabilities of T1 as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

General Liabilities .....	\$100
Taxes Payable .....	20
<b>Total .....</b>	<b>120</b>

(x) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 Stock .....	\$ 500
Liabilities .....	120
<b>AGUB .....</b>	<b>620</b>

(xi) Assume that ADSP is also \$620.

(xii) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class IV and VI assets are as follows:

Asset class	Asset	Fair market value
I .....	Cash .....	*\$50
IV .....	Inventory .....	200
VI .....	Patent .....	350
	<b>Total .....</b>	<b>600</b>

\* Amount.

(xiii) The amount of ADSP and of AGUB allocable to T1's Class IV and VI assets is first reduced by the \$50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB (\$570) is an amount which exceeds the fair market value of T1's only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value (\$200). After that, the remaining amount of ADSP and of AGUB (\$370) exceeds the fair market value of T1's only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value (\$350).

(xv) The amount of ADSP and of AGUB allocated to T1's Class VII assets (goodwill and going concern value) is \$20, i.e., \$570—\$550.

*Example 2.* (i) Assume that the facts are the same as in *Example 1* except that P has, for five years, owned 20 percent of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of \$100, and P purchases the remaining 80 percent of T's stock for \$1,600. P does not make a gain recognition election under section 338(b)(3).

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(ii) Under § 1.338-5(c), the grossed-up basis of recently purchased T stock is \$1,600, i.e.,  $\$1,600 \times (1 - .2)/.8$ .

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338-5(c) ( $\$1,600 \times (1 - .2)/.8$ ) .....	\$1,600
Basis of nonrecently purchased stock .....	100
Liabilities .....	1,000
AGUB .....	2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under § 1.338-5(c) ( $\$1,600 \times (1 - .2)/.8$ ) .....	\$1,600
Basis of nonrecently purchased stock as if the gain recognition election under § 1.338-5(d)(2) had been made ( $\$1,600 \times .2/(1 - .2)$ ) .....	400
Liabilities .....	1,000
Total .....	3,000

(v) Since the hypothetical purchase price (\$3,000) exceeds the AGUB (\$2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price (\$3,000) is allocated among the assets under the general rules of this section. The allocation is set forth in the column below entitled *Original Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets ( $\$2,700 - \$200 = \$2,500$ ) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets ( $\$3,000 - \$200 = \$2,800$ ), or  $2,500/2,800$ . This produces the *Final Allocation*:

Class	Asset	Original allocation	Final allocation
I .....	Cash .....	\$200	\$200
II .....	Portfolio of actively traded securities .....	300	*268
III .....	Accounts receivable .....	600	536
IV .....	Inventory .....	300	268
V .....	Building .....	800	714
V .....	Land .....	200	178
V .....	Investment in T1 .....	450	402
VII .....	Goodwill and going concern value .....	150	134

Class	Asset	Original allocation	Final allocation
	Total .....	3,000	2,700

\* All numbers rounded for convenience.

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### § 1.338-7 Allocation of redetermined ADSP and AGUB among target assets.

(a) *Scope.* ADSP and AGUB are redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law for the elements of ADSP or AGUB. This section provides rules for allocating redetermined ADSP or AGUB.

(b) *Allocation of redetermined ADSP and AGUB.* When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of § 1.338-6. If the allocation of the redetermined ADSP or AGUB amount under § 1.338-6 to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. (See paragraph (d) of this section for new target's treatment of the amount so allocated.) Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in § 1.338-6(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) *Special rules for ADSP—(1) Increases or decreases in deemed sale tax consequences taxable notwithstanding old target ceases to exist.* To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target is not precluded from realizing additional deemed sale tax consequences because the target is treated as a new corporation after the acquisition date.

(2) *Procedure for transactions in which section 338(h)(10) is not elected—(i) Deemed sale tax consequences included in new target's return.* If an election under